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SUBJECT: CYPRUS: ELECTION CAMPAIGN -- IT'S NOT THE ECONOMY, STUPID

REFS: (A) NICOSIA 582, (B) NICOSIA 498, (C) NICOSIA 247, (D) NICOSIA
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accordingly.

11. (SBU) Summary and Introduction. Presidential elections are now less than three months away (scheduled for February 17, 2008) and the candidates have begun their campaigning in earnest. The Cyprus problem remains far and away the leading debate issue, and will likely play the most decisive role in the election outcome. In recent weeks, the economy has also entered the picture in terms of the presidential debate, although failing to capture public attention as much as the Cyprus issue except for opposition charges of government corruption and/or incompetence in relation to a major energy infrastructure project. While the economy has performed well and should continue to demonstrate positive trends going into February, President Papadopoulos has yet to use his administration's successful economic stewardship aggressively as a campaign theme, while his opponents weakly carp that things could have been better for the poorer members of Cypriot society. Following is an analysis of the current trends in the economy, with commentary on how these might affect the election outcome. End Summary and Introduction.

Strong Growth

12. (U) The Cypriot economy continues to grow at a strong, steady pace -- 3.8 percent in 2007 -- retaining its momentum from previous years. Local economists forecast that Cyprus will maintain this growth in 2008 and 2009, outpacing the average growth rate for the EU27 (2.9 percent in 2007, and 2.4 percent in the next two years). At this pace, Cyprus is quickly closing the gap between its own GDP per capita and that of the EU. Since 2002, Cypriot GDP per capita has risen from CP 9,100 (USD 14,924 or 89.6 percent of the EU27 average) in 2002 to CP 11,600 (USD 29,000 or 93.7 percent of the EU27 average) in 2007 -- or by about 27.5 percent in local currency terms. To date, the Papadopoulos campaign has not focused public attention on the closing of this gap. The main domestic drivers of growth in Cyprus are thriving real estate and construction sectors, financial intermediation and business services, and strong domestic consumption. Tourism revenue also continued to grow in 2007, despite a small decrease in the number of tourist arrivals.

Adoption of the Euro: Going Ahead as Planned

13. (SBU) Despite a late start in the government's public education campaign, Cyprus is now well-poised for a smooth transition to the Euro on January 1, 2008 (Refs A-D), a view confirmed by the European Commission's latest assessment, released at the end of November. According to the latest Eurobarometer poll, 67 percent of Cypriots

interviewed responded that they felt they were sufficiently or very well informed about the Euro. Even though public support for the Euro has gained ground in Cyprus in recent months, 75 percent of Cypriots remain concerned about the possibility of retailers and wholesalers raising prices under cover of Euro transition. Stories of prices in Greece rising dramatically when that nation changed to the Euro feed the public apprehension. The government fully appreciates the political importance of ensuring a smooth transition to the Euro. For example, since October, all prices are required to be posted in both CP and Euros, there has been widespread publicity for the exchange rate that will prevail on transition day (precisely 0.585274 Cyprus Pounds to the Euro,) and there is a campaign to shame retailers into rounding prices down on transition day rather than round up. Also, the police are on alert to prevent any bank robberies or similar crime, given the massive amount of cash (about 1.2 billion in Euro banknotes alone, equivalent to USD 1.74 billion, and millions of Cyprus Pounds being withdrawn) that will have to be moved on Cypriot streets. The "frontloading" of commercial banks (i.e. supplying them with Euro coins and notes in advance) has already begun since October 22 for coins and since November 19 for notes. If the transition goes smoothly, analysts expect the success to be trumpeted by the Papadopoulos campaign as part of his home-stretch re-election campaign. If there are problems, the opposition candidates will take advantage of the pre-existing public concern to attack the President.

Public Finances in Excellent Shape

14. (SBU) The GOC has managed to turn around public finances in record time and ahead of its scheduled commitments to the EU. In 2007, beating earlier, more conservative forecasts for a deficit of 0.5 percent, the GOC now expects a record budget surplus of about 1.5 percent. The last time the government recorded a surplus in its accounts was 36 years ago, in 1971. The public debt is also on a downward course and forecast to reach 60 percent in 2007 - despite new government programs for lower income groups amounting to CP 125 million (USD 312 million).

15. (SBU) However, these results have failed to impress the opposition parties, which accuse the government of presenting a rosy picture and charge that "the numbers prosper in Cyprus but the people suffer." The government retorts that the sharp improvement in things fiscal has been achieved without the imposition of any new taxes. Instead, the improvement is attributed to a significant increase in tax revenue (particularly from VAT and a booming property market), on the back of a booming economy. The dramatic increase in revenue in 2007 was something of a "windfall," and is unlikely to repeat itself soon -- VAT from petroleum has rocketed along with the price of gas and a tax decrease on vehicles that went into effect in November of 2006, depressing auto sales for several months before then, contributed to a 44.4 percent increase in auto sales this year. Nevertheless, the government predicts another surplus -- albeit more modest -- for 2008, of around 0.5 percent on the back of continued strong consumer spending. The government has pointed out that, when it came to power five years ago, it inherited a fiscal deficit which had peaked at 6.3 percent in 2003, and a public debt of 68.9 percent. However, it has not made these facts an important part of its campaign theme to date.

16. (SBU) The government had been reluctant to reveal the full extent of the fiscal improvement too early in the presidential campaign, and only made the announcement after EU bureaucrats in Brussels let the cat out of the bag on November 21. Analysts ascribe this to a desire to make the announcement when it would have maximum political benefit and fear of new demands for new spending from special interest groups. Right on cue, as soon as this information became public, groups, backed by the challenging candidates (particularly, AKEL's Christofias) stepped up pressure for increased government spending on programs. So far, the Ministry of Finance has maintained a disciplined spending policy with only some small increases aimed at underprivileged groups, especially pensioners.

Tourism Losing Ground But Hanging in There

17. (SBU) Tourism remains the island's most important sector, even

though it has been stagnating over the past five years. Earnings from tourism, as well as tourist arrivals, have languished since 2002: 2006 earnings remained at just over CP 1 billion (USD 2.2 billion) and tourist arrivals remained at around 2.4 million. During the first nine months of 2007, tourist arrivals recorded a marginal (one percent) increase but a sizable (seven percent) improvement in revenue. Still, it is generally true that Cyprus tourism has been losing competitiveness in recent years to other destinations as the CP has appreciated. Fortunately for Cyprus, however, the economy is gradually becoming less dependent on tourism, with other services, particularly financial and business services, picking up the slack along with the construction sector. Over the past five years, the contribution of restaurants and hotels to GDP declined from 8.7 percent in 2002, to 7.2 percent in 2006, while that of construction increased from 7.4 percent to 8.5 percent, financial intermediation from 6.3 percent to 7.3 percent, and public administration from 9.3 percent to 10.6 percent. (Note: In analyzing GDP by sector, there is no sub-sector for "tourism" as such, since tourism feeds into many facets of the economy, and not just restaurants and hotels. The trend becomes clearer if one compares estimated revenue from tourism as a percentage of GDP, which declined from 17.6 percent in 2002 to 12.2 percent in 2006.)

Robust Retail Demand

¶18. (U) Consumer demand and consumption have remained robust throughout 2007, contributing significantly to growth. During the summer 2007 months, retail sales were up 10.0 percent, although they recorded a slight deceleration to around 7.5 percent by September ¶2007. Pharmaceuticals, cosmetics and toiletries recorded the biggest increase in sales (16.0 percent). However, as mentioned above, the clearest manifestation of strong demand conditions came in the form of new car registrations, which grew at a blistering 44.4 percent in the first ten months of 2007. Demand for both new and used automobiles increased partly because of lower taxes on cars introduced in November 2006. This evidence of consumer confidence is considered a plus for the incumbent's electoral chances.

Manufacturing on a Rebound

¶19. (U) After a long period of disappointing results, manufacturing enjoyed positive growth during 2007, fuelled mainly by domestic consumer consumption and demand for construction material related to real estate development. Manufacturing output increased by 3.2 percent on average for the period January - August 2007, compared to the same period in 2006. Overall, 10 out of 14 manufacturing categories increased their output during this period. Specifically, most of the growth came from food products, beverages and tobacco, followed by chemicals, chemical products and man-made fibers, as well as other non-metallic mineral products. By contrast, manufacturing output recorded a decrease in the sectors of leather and leather products, wood and wood products and refined petroleum products.

Real Estate and Construction: Practically on Fire

¶10. (SBU) Home selling prices have recorded strong growth during the past decade in Cyprus. During 2007, this growth accelerated to 17.5 percent year-on-year in October, giving construction activity a considerable boost. The boom in home prices and construction continues to be followed by increases in construction materials prices, which have increased by 5.0-7.0 percent in the first nine months of 2007. Building permits also recorded an increase of close to 6.0 percent during this period, while domestic cement sales increased by 9.9 percent. The adoption of the Euro as of January 1, 2008 and the anticipated imposition of VAT on land transactions as of July 1, 2008 have contributed to the increase in demand for residential housing in 2007. In an effort to cool down demand -- but with little visible success so far -- the Central Bank issued in July 2007 a directive to banks increasing cash coverage requirements for holiday homes' lending.

Money, and Financial Markets

¶11. (U) The significant growth in lending for housing and construction, both in foreign- and local-currency-denominated loans, has resulted in strong demand for liquidity by the banking sector, leading to increases in medium term deposit rates. Bank lending overall, in foreign as well local currency, reached CP 14.8 billion (USD 37 billion) in October 2007, recording an increase of 33 percent from the previous year. This rate of credit expansion is the highest in the last decade and fuels inflationary pressures (see paragraph on inflation). Personal and professional loans, which make up more than half of all loans, grew at a rate of 40 percent (supported by the collateral provided by rapidly increasing real estate values), while loans for buildings and construction, making up almost 20 percent of all loans, grew by about the same rate (40 percent) -- seemingly unperturbed by the Central Bank's recent effort to reign in housing loans.

¶12. (U) Despite the volatility shocks in August and September owing to the European financial markets response to the US subprime market crash, the Cyprus Stock Exchange index grew by about 23 percent in the first eleven months of 2007, way above most other EU financial markets.

Inflation on Watch

¶13. (U) Inflationary pressures, mainly from local services and products, remained strong during the first three quarters of 2007 but still -- barely -- within Euro-entry criteria. The consumer price index increased by 2.99 through the end of October 2007 (year on year). High energy and wheat prices worldwide, and the continuing credit expansion by the commercial banks locally, especially towards consumption and real estate, pose clear threats for accelerated inflation in the future. This trend is being exacerbated by the Central Bank's inability to raise interest rates by the end of the year, because of the need to harmonize with the Euro interest rate. The basic Cyprus interest rate (main refinancing operations rate) has remained at 4.50 percent since September 2006, i.e. 50 basis points above the Euro interest rate. Unless the Euro rate increases in the meantime, Cyprus will need to cut its own interest rate by this margin by January 1, 2008. With his inability to use monetary policy as an anti-inflationary tool, Bank of Cyprus Governor Orphanides has taken to using regulatory measures, such as increasing the down payment required for buying second homes and suggesting changes in government policy (see para. 19).

Short Term Risks

¶14. (U) Externally, a global economic slowdown, the strong Euro, a possible slowdown of the UK economy (Cyprus' largest trading partner and source of tourists), and record-high energy prices for a nation with no domestic energy reserves (yet) remain threats to economic growth next year.

¶15. (SBU) Domestically, the suspected incident of Foot and Mouth Disease (FMD) in the southeastern coast of the island continues to pose important downside risks for the government (Ref E). If the disease is confirmed and develops into an epidemic, it could have serious repercussions on the budget, with public costs likely to reach CP 60 million (USD 150 million), undermining annual economic growth estimates by as much as 0.5-1.0 percent. Coverage of the FMD in the media has been extensive to the point of obsession, overshadowing coverage of other important economic issues. Although threatening a relatively small part of the economy, FMD affects many people, meaning lots of votes. Most recent reports indicate that the FMD incidence is contained.

¶16. (SBU) The ongoing drought and ensuing water shortage have also received a fair amount of media attention in recent weeks (Ref G). With dams down to around 8 percent capacity, and no relief in sight from the sky, opposition parties have found fertile ground to accuse the government of mishandling tenders for additional desalination plants. The opposition is also accusing the government of mishandling energy tenders (Ref F) which included a statement by the leader of an opposition party stating, "I am 200 percent sure that there is a scandal with regard to the transfer of natural gas, which will cost #1 billion to the consumers." The government, through the

Commerce Minister, has responded in kind. Thus far, the charges of government corruption in these tenders have either not tended to stick or elicited a "they're all corrupt anyway" reaction among voters.

¶17. (SBU) In the medium term, the slow pace of institutional reform coupled with price inflation for local products and services raises serious concerns for competitiveness and local employment.

Longer Term Issues: Social Security Viability and COLA

¶18. (SBU) In the longer term, the most serious threat to Cyprus' continued prosperity and macroeconomic financial stability is posed by the island's aging population, which will put an increasing strain on the country's social security fund. On June 30, 2007, the fund's assets were valued at CP 3.2 billion (USD 8 billion).

¶19. (SBU) On November 26, 2007, Central Bank of Cyprus Governor Orphanides, and European Central Bank Vice President Lucas Papademos, made some controversial comments during a briefing before the House of Representatives on the economy and the possible risks lying ahead. Papademos made the point that the current state of the economy was good but that structural changes were needed to ensure future prosperity. One important change, he suggested, would be to gradually abolish the Cost of Living Allowance (COLA), which is essentially automatic indexation of wages for inflation. The suggestion drew immediate fire from AKEL and DISY MPs.

¶20. (SBU) Orphanides commented that COLA was feeding inflation through the transfer of price increases to salaries. He also called attention to the fact that Cyprus has lower productivity economy-wide but a higher government payroll than the EU average. Orphanides also commented that Cyprus was in one of the worst positions in the EU in terms of its aging population and low birth rate. He noted that, by the year 2050, the number of persons in Cyprus over 65 would double, pushing Social Security Fund (SSF) spending up to 13 percent of GDP. Citing a recent World Bank study (without disclosing further details), Orphanides advised that Cyprus should take measures now to ensure the viability of its SSF for the really long-term (up to 100 years). Otherwise, he warned, Cyprus might be forced, at some point in the future, to increase dramatically indirect taxation, such as raise VAT from the current 15 percent to 25 percent.

¶21. (SBU) These comments by Papademos and Orphanides drew concentrated fire from the majority of the parties, as well as the government. Finance Minister Sarris recognized that Orphanides was an independent official and was fully entitled to speak his mind, but stated clearly that the government has no intention of challenging the institution of COLA. Three of the four major parties -- pro-government DIKO, and EDEK, and opposition AKEL -- lashed out against any suggestion of abolishing COLA. Only opposition DISY supported the cause of a social dialogue to tackle the COLA issue. Reaction was more subdued on the SSF. Sarris admitted there was a problem with the long-term viability of the fund but noted that there was ongoing dialog among social partners as to what to do about it, with the aim of reaching consensus in the first half of 2008. Employers' organization OEB welcomed Orphanides' comments as a voice of reason, while the Cyprus Chamber of Commerce and Industry maintained a more neutral stance. Papadopoulos used the controversy over these statements to his advantage. On November 29, he declared unequivocally: "Under my presidency, there is no issue of amending COLA --end of discussion!" -- possibly to reach voters beyond his own party base.

¶22. (SBU) Comment. With the exception of FMD, and to some extent the debate over natural gas infrastructure tenders, economic issues have so far failed to capture center stage in the presidential election race. So far, Papadopoulos has been understated on the economy, letting the numbers speak for themselves for those who can understand them. If he chooses to play the economy card he could boast of rapid GDP growth, keeping inflation on a leash (despite a strong public perception that the grocery bill has increased by too much), meeting all Maastricht criteria, and above all, paving the way for a smooth transition to the Euro. Instead, Papadopoulos has focused his campaign in a laser-like fashion on the risks of the Annan Plan being resurrected--both because the Cyprus Problem always

dominates all political discussion here and because if his opponents choose to debate him on the economy, current conditions and immediate outlook give him a good story to tell. He also may be waiting for the right moment, possibly after a smooth Euro transition, to highlight economic issues. For the opposition, the structural reforms that are needed are too complex and will cause too much short-term pain for the candidates to make them successful campaign issues.

SCHLICHER